1992

Proposed statement on standards for attestation engagements : reporting on an entity's internal control structure over financial reporting : supersedes SAS No. 30, Reporting on internal accounting control;Reporting on an entity's internal control structure over financial reporting : supersedes SAS No. 30, Reporting on internal accounting control; Exposure draft (American Institute of Certified Public Accountants), 1992, Apr. 20

American Institute of Certified Public Accountants. Auditing Standards Board

EXPOSURE DRAFT

PROPOSED STATEMENT ON STANDARDS FOR ATTESTATION ENGAGEMENTS

REPORTING ON AN ENTITY'S INTERNAL CONTROL STRUCTURE OVER FINANCIAL REPORTING

(Supersedes SAS No. 30,
***Reporting on Internal Accounting Control*)**

APRIL 20, 1992

Prepared by the AICPA Auditing Standards Board
For comment from persons interested in auditing and reporting

Comments should be received by August 14, 1992, and addressed to
A. Louise Williamson, Technical Manager, Auditing Standards Division, File 4287
AICPA, 1211 Avenue of the Americas, New York, N.Y. 10036–8775

SUMMARY

Why Issued

The Auditing Standards Board is considering the issuance of this proposed statement on standards for attestation engagements to provide guidance to practitioners who are engaged to examine and report on management's written assertion about the effectiveness of an entity's internal control structure over financial reporting.

What It Does

This proposed Statement provides guidance to assist the practitioner in—

- Accepting an engagement.
- Planning the engagement.
- Obtaining an understanding of the internal control structure.
- Testing and evaluating the design effectiveness and the operating effectiveness of internal control structure policies and procedures.
- Forming an opinion on management's assertion, using material weakness as the basis for determining whether the practitioner's opinion should be modified.
- Communicating reportable conditions.

This proposed guidance would apply to auditors of insured depository institutions who examine management's assertions about the effectiveness of the internal control structure over financial reporting, as required by the Federal Deposit Insurance Corporation Improvement Act of 1991.

How It Would Change Existing Standards

This proposed Statement would supersede Statement on Auditing Standards (SAS) No. 30, *Reporting on Internal Accounting Control* (AICPA, *Professional Standards*, vol. 1, AU sec. 642). It differs from SAS No. 30 in that the proposed Statement—

- Requires practitioners to consider whether management's assertion is based on reasonable criteria against which it can be evaluated, and whether the assertion is capable of reasonably consistent estimates or measurement using those criteria. (Unlike SAS No. 30, this proposed Statement does not define the specific criteria.)
- Precludes the practitioner from reporting directly on the company's internal control structure. (Unlike SAS No. 30, this proposed Statement does not allow the practitioner to report directly on the company's internal control structure. Instead, the practitioner reports on management's assertion only.)
- Precludes the practitioner from issuing a public report unless management's assertion is included in a separate written report that accompanies the practitioner's report.
- Requires the practitioner to limit his or her report on management's assertion about the company's internal control structure when management elects to present its assertion only in a representation letter and not in a separate written report.
- Updates the definition of internal control, including terminology and concepts that are consistent with SAS No. 55, *Consideration of the Internal Control Structure in a Financial Statement Audit.*

This exposure draft has been sent to—

- *Practice offices of CPA firms.*
- *Members of the AICPA Council and technical committees.*
- *State society and chapter presidents, directors, and committee chairpersons.*
- *Organizations concerned with regulatory, supervisory, or other public disclosure of financial activities.*
- *Persons who have requested copies.*

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April 20, 1992

Accompanying this letter is an exposure draft, approved by the Auditing Standards Board, of a proposed statement on standards for attestation engagements titled *Reporting on an Entity's Internal Control Structure Over Financial Reporting*. This proposed Statement would supersede Statement on Auditing Standards No. 30, *Reporting on Internal Accounting Control*. A summary of the proposed Statement also accompanies this letter.

Comments or suggestions on any aspect of this exposure draft will be appreciated. To facilitate consideration of responses by the Auditing Standards Board, comments should refer to specific paragraphs and include supporting reasons for each suggestion or comment.

In developing guidance, the Auditing Standards Board considers the relationship between the cost imposed and the benefits reasonably expected to be derived from attestation engagements. It also considers the differences that an auditor may encounter in an attestation engagement involving small businesses and, when appropriate, makes special provisions to meet those needs. Thus, the Board would particularly appreciate comments on those matters.

Written comments on the exposure draft will become part of the public record of the AICPA Auditing Standards Division and will be available for public inspection at the offices of the AICPA after September 14, 1992, for one year. Responses should be sent to the Auditing Standards Division, File 4287, in time to be received by August 14, 1992.

Sincerely,

Donald L. Neebes

Donald L. Neebes
Chairman
Auditing Standards Board

Dan M. Guy

Dan M. Guy
Vice President
Auditing Standards Division

TABLE OF CONTENTS

PROPOSED STATEMENT ON STANDARDS FOR ATTESTATION ENGAGEMENTS

REPORTING ON AN ENTITY'S INTERNAL CONTROL STRUCTURE OVER FINANCIAL REPORTING

APPLICABILITY

1. This Statement provides guidance to the practitioner who is engaged to examine and report on management's written assertion about the effectiveness of an entity's internal control structure over financial reporting *as of a point in time*.[1] An entity's internal control structure over financial reporting[2] includes those policies and procedures that pertain to an entity's ability to record, process, summarize, and report financial data consistent with the assertions embodied in either annual financial statements or interim financial statements, or both.[3] A practitioner engaged to examine and report on management's assertion about the effectiveness of an entity's internal control structure should comply with the general, fieldwork, and reporting standards in the Statement on Standards for Attestation Engagements (SSAE) *Attestation Standards* (AICPA, *Professional Standards*, vol. 1, AT sec. 100), and the specific performance and reporting standards set forth in this Statement.

2. Management may present its written assertion about the effectiveness of the entity's internal control structure in either of two forms:

a. A separate report that will accompany the practitioner's report

b. A representation letter to the practitioner (in this case, however, the practitioner should restrict the use of his or her report to management and others within the entity and, if applicable, to specified regulatory agencies)

A practitioner should not consent to the use of his or her examination report on management's assertion about the effectiveness of an entity's internal control structure in a general-use document unless management presents its written assertion in a separate report that will accompany the practitioner's report.

3. Management's written assertion about the effectiveness of an entity's internal control structure may take various forms. Throughout this document, for example, the phrase, "management's assertion that W Company maintained an effective internal control structure over financial reporting as of [*date*]," illustrates such an assertion. Other phrases, such as "management's assertion that W Company's internal control structure over financial reporting is sufficient to meet the stated objectives" may also be used. However, a practitioner should not provide assurance on an assertion that is so subjective (for example, a "very effective" internal control structure) that people having competence in and using the same or similar measurement and disclosure criteria would not ordinarily be able to attain materially similar estimates or measurements.

4. The guidance in this Statement does not apply if management does not present a written assertion. In this situation, there is no assertion by management on which the practitioner can provide assurance. However, management may engage the practitioner to provide certain nonattest services in connection with the entity's internal control structure. For example, management may engage the practitioner to provide recommendations on improvements to the entity's internal control structure. A practitioner engaged to provide such nonattest services should consider the guidance in the Statement on Standards for Consulting Services (AICPA, *Professional Standards*, vol. 2, CS sec. 100).

OTHER ATTEST SERVICES

5. A practitioner may also be engaged to provide other types of services in connection with an entity's internal control structure. For example, he or she may be engaged to apply *agreed-upon procedures* to and report on management's assertion about the effectiveness of the entity's internal control structure. For such engagements, the practitioner should refer to the guidance in the *Attestation Standards*.

6. Although a practitioner may *examine* or *apply agreed-upon procedures* to management's assertion about the effectiveness of the entity's internal control structure, he or she should not accept an engagement to *review* and report on such a management assertion.

7. The appendix presents a listing of Statements on Auditing Standards that provide guidance for a practitioner engaged to provide other services in connection with an entity's internal control structure. Under the Securities Exchange Act of 1934, certain reports on the entity's internal control structure are

[1] Ordinarily, management will present its assertion about the effectiveness of the entity's internal control structure over financial reporting as of the end of the entity's fiscal year; however, management may select a different date for its assertion. A practitioner also may be engaged to examine and report on management's assertion about the effectiveness of an entity's internal control structure over financial reporting *during a period of time*. In that case, the guidance in this Statement should be modified accordingly.

[2] Throughout this Statement, an entity's internal control structure over financial reporting is referred to simply as its "internal control structure."

[3] A practitioner engaged to provide assurances on management's assertion about the effectiveness of an entity's internal control structure other than over financial reporting (for example, controls over safeguarding of assets other than those described in paragraph 25*c*, or other operating controls or controls over compliance with laws and regulations) should refer to the guidance in the Statement on Standards for Attestation Engagements (SSAE) *Attestation Standards* (AICPA, *Professional Standards*, vol. 1, AT sec. 100) and to paragraph 7 of this Statement.

required. Rule 17a-5 requires such a report for a broker or dealer in securities. AICPA Statement of Position (SOP) 89-4, *Reports on the Internal Control Structure of Brokers and Dealers in Securities*, contains a sample report that a practitioner might use in such circumstances. In addition, Form N-SAR requires a report on the internal control structure of an investment company. A sample report that a practitioner might use in such situations is included in the Audit and Accounting Guide *Audits of Investment Companies*, published by the American Institute of Certified Public Accountants. Such information, included in the Appendix to this Statement, in Rule 17a-5, and in Form N-SAR, is not covered by this Statement.

CONDITIONS FOR ENGAGEMENT ACCEPTANCE

8. A practitioner may *examine* and report on management's assertion about the effectiveness of an entity's internal control structure if the following conditions are met:

a. Management is sufficiently knowledgeable about the entity's internal control structure to accept responsibility for the assertion about the effectiveness of the entity's internal control structure.

b. Management evaluates the effectiveness of the entity's internal control structure using reasonable criteria for effective internal control structures established by a recognized body. Such criteria are referred to as "control criteria" throughout this Statement.[4]

c. Sufficient competent evidential matter exists or could be developed to support management's evaluation.

d. Management presents its written assertion, as discussed in paragraph 2, about the effectiveness of the entity's internal control structure based upon the control criteria referred to in its report.

9. Management is responsible for maintaining an effective internal control structure. In some cases, management may evaluate and report on the effectiveness of that structure without the practitioner's assistance. However, management may engage the practitioner to gather information to enable management to evaluate the effectiveness of the entity's internal control structure.

ELEMENTS OF AN ENTITY'S INTERNAL CONTROL STRUCTURE

10. The elements that constitute an entity's internal control structure are a function of the definition of an internal control structure selected by management. For example, management may select the definition of an internal control structure contained in Statement on Auditing Standards (SAS) No. 55, *Consideration of the Internal Control Structure in a Financial Statement Audit* (AICPA, *Professional Standards*, vol. 1, AU sec. 319). Paragraphs 11 through 14 describe the elements that constitute an entity's internal control structure as defined in SAS No. 55. If management selects another definition of an internal control structure, the description of the elements contained in those paragraphs may not be relevant.

11. SAS No. 55 describes an entity's internal control structure as consisting of three elements—the control environment, the accounting system, and control procedures—and including the policies and procedures established to provide reasonable assurance that specific entity objectives are achieved.

12. An entity's control environment reflects the overall attitude, awareness, and actions of the board of directors, management, owners, and others concerning the importance of control and the emphasis placed on it within the entity. It represents the collective effects of various factors, described in paragraph 25*a*, on establishing, enhancing, or mitigating the effectiveness of specific internal control structure policies and procedures. An effective control environment interacts with elements of the accounting system and with control procedures to help provide reasonable assurance that specific entity objectives are achieved.

13. As further described in paragraph 25*b*, the entity's accounting system consists of the methods and records established to identify, assemble, analyze, classify, record, and report an entity's transactions and to maintain accountability for the related assets and liabilities.

14. Control procedures are those policies and procedures in addition to the control environment and accounting system that management establishes to help ensure that specific entity objectives are met. As described in paragraph 25*c*, they have various objectives and are applied at various organizational and data processing levels within an entity. They may also be integrated into specific components of the control environment and the accounting system.

LIMITATIONS OF AN ENTITY'S INTERNAL CONTROL STRUCTURE

15. There are inherent limitations that should be recognized when considering the effectiveness of any internal control structure. In the application of many control policies and procedures, the potential exists for errors to arise from causes such as misunderstood instructions, mistakes in judgment, and personal carelessness, distraction, or fatigue. Furthermore, policies and procedures whose effectiveness depends on segregation of duties can be circumvented by collusion. Similarly, irregularities perpetrated by manage-

[4] Criteria issued by the AICPA, regulatory agencies, and other bodies composed of experts that follow due process procedures, including procedures for broad distribution of proposed criteria for public comment, usually should be considered reasonable criteria for this purpose.

Criteria established by a regulatory agency that do not follow such due process procedures also may be considered reasonable criteria for use by the regulatory agency. However, the practitioner would have to modify his or her report by adding a paragraph that limits its distribution to those within the entity and to the regulatory agency (see paragraphs 72 through 76).

ment may not be susceptible to prevention or detection by specific control policies or procedures, because management may not be subject to the controls that deter employees or may override those controls.

16. Custom, culture, and the corporate governance system may inhibit irregularities by management, but they are not infallible deterrents. An effective control environment, too, may help mitigate the probability of such irregularities. For example, control environment factors such as an effective board of directors, audit committee, and internal audit function may constrain improper conduct by management. Alternatively, an ineffective control environment may negate the effectiveness of control policies and procedures within the accounting system and other control procedures. For example, although an entity has good controls relating to the financial reporting process, a strong bias on the part of management to inflate reported earnings to maximize bonuses may result in financial statements that are materially misstated. The effectiveness of an entity's internal control structure might also be adversely affected by such factors as a change in ownership or control, changes in management or other personnel, or developments in the entity's market or industry.

EXAMINATION ENGAGEMENT

17. The practitioner's objective in an engagement to examine and report on management's assertion about the effectiveness of the entity's internal control structure is to express an opinion about whether management's assertion regarding the effectiveness of the entity's internal control structure is fairly stated, in all material respects, based upon the control criteria. The practitioner's opinion relates to the fair presentation of management's assertion about the effectiveness of the entity's internal control structure taken as a whole, and not to the effectiveness of each individual element (control environment, accounting system, and control procedures) of the entity's internal control structure. Therefore, the practitioner considers the interrelationship of the elements of an entity's internal control structure in achieving the objectives of the control criteria. To express an opinion on management's assertion, the practitioner accumulates sufficient evidence about the design and operating effectiveness of the entity's internal control structure to attest to management's assertion, thereby limiting attestation risk to an appropriately low level. When evaluating the design effectiveness of specific control policies and procedures, the practitioner considers whether the control policy or procedure is suitably designed to prevent or detect material misstatements on a timely basis. When evaluating operating effectiveness, the practitioner considers how the policy or procedure was applied, the consistency with which it was applied, and by whom it was applied.

18. Performing an examination of management's assertion about the effectiveness of an entity's internal control structure involves (*a*) planning the engagement, (*b*) obtaining an understanding of the internal control structure, (*c*) testing and evaluating the design effectiveness of the internal control structure policies and procedures, (*d*) testing and evaluating the operating effectiveness of the internal control structure policies and procedures, and (*e*) forming an opinion about whether management's assertion regarding the effectiveness of the entity's internal control structure is fairly stated, in all material respects, based on the control criteria.

Planning the Engagement

19. *General Considerations.* Planning an engagement to examine and report on management's assertion about the effectiveness of the entity's internal control structure involves developing an overall strategy for the scope and performance of the engagement. When developing an overall strategy for the engagement, the practitioner should consider factors such as the following:

- Matters affecting the industry in which the entity operates, such as financial reporting practices, economic conditions, government regulations, and technological changes
- Matters relating to the entity's business, including its organization, operating characteristics, capital structure, and distribution methods
- Knowledge of the entity's internal control structure obtained during other professional engagements
- The extent of recent changes, if any, in the entity, its operations, or its internal control structure
- Management's method of evaluating the effectiveness of the entity's internal control structure based upon the control criteria
- Preliminary judgments about materiality levels, inherent risk, and other factors relating to the determination of material weaknesses
- The type and extent of evidential matter supporting management's assertion about the effectiveness of the entity's internal control structure
- The nature of specific internal control structure policies and procedures designed to achieve the objectives of the control criteria, and their significance to the internal control structure taken as a whole
- Preliminary judgments about the effectiveness of the internal control structure

20. *Multiple Locations.* A practitioner planning an engagement to examine management's assertion about the effectiveness of the internal control structure of an entity with operations in several locations should consider factors similar to those he or she would consider in performing an audit of the financial statements of an entity with multiple locations. It may not be necessary to understand and test controls at each location. In addition to the factors listed in paragraph 19, the selection of locations should be based on

factors such as (*a*) the similarity of business operations and internal control structures at the various locations, (*b*) the degree of centralization of records, (*c*) the effectiveness of control environment policies and procedures, particularly those that affect management's direct control over the exercise of authority delegated to others and its ability to effectively supervise activities at the various locations, and (*d*) the nature and amount of transactions executed and related assets at the various locations.

21. *Internal Audit Function.* Another factor the practitioner should consider when planning the engagement is whether the entity has an internal audit function. An important responsibility of the internal audit function is to monitor the performance of an entity's controls. One way internal auditors monitor such performance is by performing tests that provide evidence about the effectiveness of the design and operation of specific internal control structure policies and procedures. The results of these tests are often an important basis for management's assertions about the effectiveness of the entity's internal control structure. A practitioner may find the guidance in SAS No. 65, *The Auditor's Consideration of the Internal Audit Function in an Audit of Financial Statements* (AICPA, *Professional Standards*, vol. 1, AU sec. 322), helpful when assessing the competence and objectivity of internal auditors, the extent of work to be performed, and other matters.

22. *Documentation.* Internal control structure policies and procedures and the control objectives that they were designed to achieve should be appropriately documented to serve as a basis for management's and the practitioner's reports. Such documentation is generally prepared by management. However, at management's request, the practitioner may assist in preparing or gathering such documentation. This documentation may take various forms: entity policy manuals, accounting manuals, narrative memoranda, flowcharts, decision tables, procedural write-ups, or completed questionnaires. No one particular form of documentation is necessary, and the extent of documentation may vary depending upon the size and complexity of the entity.

Obtaining an Understanding of the Internal Control Structure

23. A practitioner generally obtains an understanding of the design of specific policies and procedures by making inquiries of appropriate management, supervisory, and staff personnel; by inspecting entity documents; and by observing entity activities and operations. The nature and extent of the procedures a practitioner performs vary from entity to entity and are influenced by his or her knowledge of the internal control structure obtained in previous professional engagements, understanding of the industry in which the entity operates, and judgments about materiality.

Testing and Evaluating the Design Effectiveness of Internal Control Structure Policies and Procedures

24. As discussed in paragraph 10, the elements that constitute an entity's internal control structure are a function of the definition of an internal control structure selected by management. Paragraph 25 describes the elements of the internal control structure that the practitioner should understand if management decides to evaluate and report on the entity's internal control structure based on the definition of an internal control structure contained in SAS No. 55. If management selects another definition of an internal control structure, the description of the elements contained in paragraph 25 may not be relevant.

25. To evaluate the design of an entity's internal control structure, the practitioner should obtain an understanding of the internal control structure policies and procedures within each element (control environment, accounting system, and control procedures) of the internal control structure. These elements are described below.

a. An entity's control environment includes—
- Management's philosophy and operating style.
- The entity's organizational structure.
- The functioning of the board of directors and its committees, particularly the audit committee.
- Methods of assigning authority and responsibility.
- Management's control methods for monitoring and following up on performance, including internal auditing.
- Personnel policies and practices.
- Various external influences that affect an entity's operations, such as examinations by regulatory agencies.

b. An entity's accounting system consists of the methods and records established to identify, assemble, analyze, classify, record, and report an entity's transactions and to maintain accountability for the related assets and liabilities. An effective accounting system gives appropriate consideration to establishing methods and records that will—
- Identify and record all valid transactions.
- Describe the transactions on a timely basis and in sufficient detail to permit proper classification for financial reporting.
- Measure the value of transactions in a manner that permits reporting of their proper monetary value in the financial statements.
- Determine the time period in which transactions occurred to permit recording of transactions in the proper accounting period.
- Present properly the transactions and related disclosures in the financial statements.

c. An entity's control procedures may be categorized as procedures that pertain to—

- Proper authorization of transactions and activities.
- Segregation of duties to reduce the opportunity of any person to both perpetrate and conceal errors or irregularities in the normal course of his or her duties. It includes assigning to different people the responsibilities of authorizing transactions, recording transactions, and maintaining custody of assets.
- Design and use of adequate documents and records, and appropriate monitoring, to help ensure the proper recording of transactions and events. This includes the monitoring of prenumbered shipping documents.
- Adequate safeguards over access to and use of assets and records. These include secured facilities and authorized access to computer programs and data files.
- Independent checks on performance and proper valuation of recorded amounts. These include clerical checks, reconciliations, comparison of assets with recorded accountability, computer-programmed controls, management review of reports that summarize the details of account balances (for example, an aged trial balance of accounts receivable), and user review of computer-generated reports.

In the context of an entity's internal control structure, safeguarding of assets refers only to protection against loss from errors and irregularities in the processing of transactions and the handling of related assets. It does not include, for example, loss of assets arising from management's operating decisions, such as selling a product that proves to be unprofitable, incurring expenditures for equipment or material that proves to be unnecessary or unsatisfactory, authorizing what proves to be unproductive research or ineffective advertising, or accepting some level of merchandise pilferage by customers as part of operating a retail business.

26. Any of the elements of the internal control structure may include policies and procedures designed to achieve the objectives of the control criteria. Some control structure policies and procedures may have a pervasive effect on achieving many overall objectives of these criteria. For example, computer general controls over program development, program changes, computer operations, and access to programs and data help assure that specific controls over the processing of transactions are operating effectively. In contrast, other control structure policies and procedures are designed to achieve specific objectives of the control criteria. For example, management generally establishes specific control policies and procedures, such as accounting for all shipping documents, to ensure that all valid sales are recorded.

27. The practitioner should focus on the significance of internal control structure policies and procedures in achieving the objectives of the control criteria rather than on specific policies and procedures in isolation. The absence or inadequacy of a specific policy or procedure designed to achieve the objectives of a specific criterion may not be a deficiency if other policies or procedures specifically address the same criterion. Further, when one or more internal control structure policy or procedure achieves the objectives of a specific criterion, the practitioner may not need to consider other policies or procedures designed to achieve those same objectives.

28. Tests of the effectiveness of the design of a specific internal control structure policy or procedure are concerned with whether that policy or procedure is suitably designed to prevent or detect material misstatements in specific financial statement assertions. Such tests will vary depending upon the nature of the specific policy or procedure, the nature of the entity's documentation of the specific policy or procedure, and the complexity and sophistication of the entity's operations and systems.

Testing and Evaluating the Operating Effectiveness of Internal Control Structure Policies and Procedures

29. To evaluate the operating effectiveness of an entity's internal control structure, the practitioner performs tests of relevant control structure policies and procedures to obtain sufficient evidence to support the opinion in the report. Tests of the operating effectiveness of an internal control structure policy or procedure are concerned with how the policy or procedure was applied, the consistency with which it was applied, and by whom it was applied. Such tests ordinarily include inquiries of appropriate personnel, inspection of relevant documentation, observation of the entity's operations, and reapplication or reperformance of the internal control structure procedure.

30. The evidential matter that is sufficient to support a practitioner's opinion on management's assertion is a matter of professional judgment. However, the practitioner should consider matters such as the following:

- The nature of the internal control structure policy or procedure
- The significance of the internal control structure policy or procedure in achieving the objectives of the control criteria
- The nature and extent of tests of the operating effectiveness of internal control structure policies and procedures performed by the entity, if any
- The risk of noncompliance with the internal control structure policy or procedure, which might be assessed by considering the following:
  - Whether there have been changes in the volume or nature of transactions that might adversely affect control design or operating effectiveness
  - Whether there have been changes in controls
  - The degree to which the control relies on the effectiveness of other controls (for example, control environment policies and procedures or computer general controls)

- Whether there have been changes in key personnel who perform the control or monitor its performance
- Whether the control relies on performance by an individual or by electronic equipment
- The complexity of the control policy or procedure
- Whether more than one control achieves a specific objective

31. Management or other entity personnel may perform tests of the operating effectiveness of certain internal control structure policies and procedures and provide the practitioner with the results of such tests. Although the practitioner should consider the results of such tests when evaluating the operating effectiveness of control structure policies and procedures, it is the practitioner's responsibility to obtain sufficient evidence to support his or her opinion. When evaluating whether sufficient evidence has been obtained, the practitioner should consider that evidence obtained through his or her direct personal knowledge, observation, reperformance, and inspection is more persuasive than information obtained indirectly, such as from management or other entity personnel. Further, judgments about the sufficiency of evidence obtained and other factors affecting the practitioner's opinion, such as the materiality of identified control deficiencies, should be those of the practitioner.

32. The nature of the policies and procedures influences the nature of the tests of controls the practitioner can perform. For example, the practitioner may examine documents regarding control structure policies and procedures for which documentary evidence exists. However, documentary evidence regarding some control environment policies and procedures (such as management's philosophy and operating style) often does not exist. In these circumstances, the practitioner's tests of controls would consist of inquiries of appropriate personnel and observation of entity activities. The practitioner's preliminary judgments about the effectiveness of control environment policies and procedures often influence the nature, timing, and extent of the tests of controls to be performed to obtain evidence about the operating effectiveness of control structure policies and procedures in the accounting system and other control procedures.

33. The period of time over which the practitioner should perform tests of controls is a matter of judgment; however, it varies with the nature of the control policies and procedures being tested and with the frequency with which specific control procedures operate and specific policies are applied. Some control structure policies and procedures operate continuously (for example, controls over sales) while others operate only at certain times (for example, controls over the preparation of interim financial statements and controls over physical inventory). The practitioner should perform tests of controls over a period of time that is adequate to determine whether, as of the date selected by management for its assertion, the control structure policies and procedures necessary for achieving the objectives of the control criteria are operating effectively.

34. Management may present a written assertion about the effectiveness of internal control structure policies and procedures related to the preparation of interim financial information. Depending on management's assertion, the practitioner should consider whether to perform tests of internal control structure policies and procedures in effect during one or more interim periods to form an opinion about the effectiveness of such policies and procedures in achieving the related interim reporting objectives.

35. Prior to the date as of which it presents its assertion, management may change the entity's internal control structure policies and procedures to make them more effective or efficient, or to address control deficiencies. In these circumstances, the practitioner may not need to consider control structure policies or procedures that have been superseded. For example, if the practitioner determines that the new control policies or procedures achieve the related objectives of the control criteria and have been in effect for a sufficient period to permit the practitioner to assess their design and operating effectiveness by performing tests of controls, the practitioner will not need to consider the design and operating effectiveness of the superseded control structure policies or procedures.

Forming an Opinion on Management's Assertion

36. When forming an opinion on management's assertion about the effectiveness of an entity's internal control structure, the practitioner should consider all evidence obtained, including the results of the tests of controls and any identified control deficiencies, to evaluate the design and operating effectiveness of the internal control structure policies and procedures based on the control criteria.

DEFICIENCIES IN AN ENTITY'S INTERNAL CONTROL STRUCTURE

37. During the course of the engagement, the practitioner may become aware of significant deficiencies in the entity's internal control structure. The practitioner's responsibility to communicate such deficiencies is described in paragraphs 43 and 44.

Reportable Conditions

38. SAS No. 60, *Communication of Internal Control Structure Related Matters Noted in an Audit* (AICPA, *Professional Standards*, vol. 1, AU sec. 325), defines reportable conditions as matters coming to an auditor's attention that represent significant deficiencies in the design or operation of the internal control structure that could adversely affect the entity's ability to record, process, summarize, and report financial data consistent

with the assertions of management in the financial statements.

Material Weaknesses

39. A reportable condition may be of such magnitude as to be considered a material weakness. SAS No. 60 defines a material weakness as a condition in which the design or operation of one or more of the specific internal control structure elements do not reduce to a relatively low level the risk that errors or irregularities in amounts that would be material in relation to the financial statements may occur and not be detected within a timely period by employees in the normal course of performing their assigned functions. Therefore, the presence of a material weakness will preclude management from asserting that the entity has an effective internal control structure. However, depending on the significance of the material weakness and its effect on the achievement of the objectives of the control criteria, management may qualify its assertion (that is, assert that the internal control structure is effective "except for" the material weakness noted).[5]

40. When evaluating whether a reportable condition is also a material weakness, the practitioner should recognize that—

a. The amounts of errors or irregularities that might occur and remain undetected range from zero to the gross financial statement amounts or transactions that are exposed to the reportable condition.

b. The risk of errors or irregularities is likely to be different for the different possible amounts within that range. For example, the risk of errors or irregularities in amounts equal to the gross exposure might be very low, but the risk of smaller amounts might be progressively greater.

41. In evaluating whether the combined effect of individual reportable conditions results in a material weakness, the practitioner should consider—

a. The range or distribution of the amounts of error or irregularities that may result during the same accounting period from two or more individual reportable conditions.

b. The joint risk or probability that such a combination of errors or irregularities would be material.

42. Evaluating whether a reportable condition is also a material weakness is a subjective process that depends on such factors as the nature of the accounting system and of any financial statement amounts or transactions exposed to the reportable condition, the overall control environment, other control procedures, and the judgment of those making the evaluation.

Communicating Reportable Conditions and Material Weaknesses

43. A practitioner engaged to examine and report on management's assertion about the effectiveness of the entity's internal control structure should communicate reportable conditions to the audit committee[6] and identify the reportable conditions that are also considered to be material weaknesses. Such a communication should preferably be made in writing.

44. Because timely communication may be important, the practitioner may choose to communicate significant matters during the course of the examination rather than after the examination is concluded. The decision about whether an interim communication should be issued would be influenced by the relative significance of the matters noted and the urgency of corrective follow-up action.

MANAGEMENT'S REPRESENTATIONS

45. The practitioner should obtain written representations from management—[7]

a. Acknowledging management's responsibility for establishing and maintaining the internal control structure.

b. Stating that management has performed an evaluation of the effectiveness of the entity's internal control structure and specifying the control criteria used.

c. Stating management's assertion about the effectiveness of the entity's internal control structure based upon the control criteria.

d. Stating that management has disclosed to the practitioner all reportable conditions and identified those that it believes to be material weaknesses in the internal control structure.

e. Describing any material irregularities and any other irregularities that, although not material, involve management or other employees who have a significant role in the entity's internal control structure.

f. Stating whether there were, subsequent to the date of management's report, any changes in the internal control structure or other factors that might significantly affect the internal control structure, including any corrective actions taken by management with regard to significant deficiencies and material weaknesses.

REPORTING STANDARDS

46. The form of the practitioner's report depends on the manner in which management presents its written assertion.

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[5] Paragraphs 53 through 61 contain guidance the practitioner should consider when reporting on a management assertion that contains, or should contain, a description of a material weakness.

[6] If the entity does not have an audit committee, the practitioner should communicate with individuals whose authority and responsibility are equivalent to those of an audit committee, such as the board of directors, the board of trustees, an owner in an owner-managed entity, or those who engaged the practitioner.

[7] Paragraph 9 of SAS No. 19, *Client Representations* (AICPA, *Professional Standards*, vol. 1, AU sec. 333), provides guidance on the date as of which management should sign such a representation letter and the date on which member(s) of management should sign it.

a. If management's assertion is presented in a separate report that accompanies the practitioner's report, the report is considered appropriate for general distribution and the practitioner should use the form of report discussed in paragraphs 47 and 48.

b. If management presents its assertion only in a representation letter to the practitioner, the practitioner should restrict the distribution of the report to management, to others within the entity, and, if applicable, to specified regulatory agencies, and the practitioner should use the form of report discussed in paragraphs 49 through 51.

Management's Assertion Presented in a Separate Report

47. When management presents its assertion in a separate report that will accompany the practitioner's report, the practitioner's report should include—

a. An identification of management's assertion about the effectiveness of the entity's internal control structure over financial reporting.

b. A statement that the examination was made in accordance with standards established by the American Institute of Certified Public Accountants and, accordingly, that it included obtaining an understanding of the internal control structure over financial reporting, testing and evaluating the design and operating effectiveness of the internal control structure, and such other procedures as the practitioner considered necessary in the circumstances. In addition, the report should include a statement that the practitioner believes the examination provides a reasonable basis for his or her opinion.

c. A paragraph stating that, because of inherent limitations of any internal control structure, errors or irregularities may occur and not be detected. In addition, the paragraph should state that projections of any evaluation of the internal control structure over financial reporting to future periods are subject to the risk that the internal control structure may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

d. The practitioner's opinion on whether management's assertion about the effectiveness of the entity's internal control structure over financial reporting as of the specified date is fairly stated, in all material respects, based on the control criteria.

48. The following is the form of report a practitioner should use when he or she has examined management's assertion about the effectiveness of an entity's internal control structure as of a specified date.

Independent Accountant's Report

[*Introductory paragraph*]

We have examined management's assertion [*identify management's assertion, for example, that W Company maintained an effective internal control structure over financial reporting as of December 31, 19XX*] included in the accompanying [*title of management report*].[8]

[*Scope paragraph*]

Our examination was made in accordance with standards established by the American Institute of Certified Public Accountants and, accordingly, included obtaining an understanding of the internal control structure over financial reporting, testing and evaluating the design and operating effectiveness of the internal control structure, and such other procedures as we considered necessary in the circumstances. We believe that our examination provides a reasonable basis for our opinion.

[*Inherent limitations paragraph*]

Because of inherent limitations in any internal control structure, errors or irregularities may occur and not be detected. Also, projections of any evaluation of the internal control structure over financial reporting to future periods are subject to the risk that the internal control structure may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

[*Opinion paragraph*]

In our opinion, management's assertion [*identify management's assertion, for example, that W Company maintained an effective internal control structure over financial reporting as of December 31, 19XX*] is fairly stated, in all material respects, based upon [*identify established or stated criteria*].

Management's Assertion Presented Only in a Letter of Representation to the Practitioner

49. Sometimes, management may present its written assertion about the effectiveness of the entity's internal control structure in a representation letter to the practitioner but not in a separate report that accompanies the practitioner's report. For example, an entity's board of directors may request the practitioner to report on management's assertion without requiring management to present a separate written assertion.

50. Paragraph 46 of the SSAE *Attestation Standards* states:

> The practitioner who accepts an attest engagement should issue a report on the assertions or withdraw from the attest engagement. When a report is issued, the assertions should be identified by referring to a separate presentation of assertions that is the responsibility of the asserter. The presentation of assertions should generally be bound with or accompany the practitioner's report. Because the asserter's responsibility for the assertion should be clear, it is ordinarily not sufficient merely to include the assertion in the practitioner's report.

When management does not present a written assertion that accompanies the practitioner's report, the practitioner should modify the report

[8] The practitioner should identify the management report examined by referring to the title used by management in its report. Further, he or she should use the same description of the entity's internal control structure as management uses in its report, including the types of controls (that is, controls over the preparation of annual financial statements, interim financial statements, or both) on which management is reporting.

to include management's assertion about the effectiveness of the entity's internal control structure and add a paragraph that limits the distribution of the report to management, to others within the entity, and, if applicable, to a specified regulatory agency.

51. A sample report that a practitioner might use in such circumstances follows.

Independent Accountant's Report

[*Introductory paragraph*]

We have examined management's assertion, included in its representation letter dated February 15, 19XY, that [*identify management's assertion, for example, W Company maintained an effective internal control structure over financial reporting as of December 31, 19XX*].

[*Standard scope, inherent limitations, and opinion paragraphs*]

[*Limitation on distribution paragraph*]

This report is intended for the information and use of the board of directors and management of W Company [*and, if applicable, a specified regulatory agency*] and should not be used by third parties for any other purpose.

REPORT MODIFICATIONS

52. The practitioner should modify the standard reports in paragraphs 48 and 51 if any of the following conditions exist:

a. There is a material weakness in the entity's internal control structure (paragraphs 53 through 61).

b. There is a restriction on the scope of the engagement (paragraphs 62 through 64).

c. The practitioner decides to refer to the report of another practitioner as the basis, in part, for the practitioner's own report (paragraphs 65 and 66).

d. A significant subsequent event has occurred since the date of management's assertion (paragraphs 67 through 69).

e. Management presents an assertion about the effectiveness of only a segment of the entity's internal control structure (paragraph 70).

f. Management presents an assertion only about the suitability of design of the entity's internal control structure (paragraphs 71 and 72).

g. Management's assertion is based upon criteria established by a regulatory agency without following due process (paragraphs 73 through 77).

Material Weaknesses

53. If the examination discloses conditions that, individually or in combination, result in one or more material weaknesses (paragraphs 39 through 42), the practitioner should modify the report. The nature of the modification depends on whether management includes, in its assertion, a description of the weakness and its significance in the achievement of the objectives of the control criteria.

54. *Management Includes the Material Weakness in its Assertion.* If management includes in its assertion a description of the weakness and its effect on the achievement of the objectives of the control criteria, and if it appropriately modifies its assertion about the effectiveness of the entity's internal control structure in light of that weakness,[9] the practitioner should both modify the opinion paragraph by including a reference to the material weakness and add an explanatory paragraph (following the opinion paragraph) that describes the weakness.

55. The following is the form of the report, modified with explanatory language, that a practitioner should use when management includes in its assertion a description of the weakness and its effect on the achievement of the objectives of the control criteria, and when it appropriately modifies its assertion about the effectiveness of the entity's internal control structure in light of that weakness.

Independent Accountant's Report

[*Standard introductory, scope, and inherent limitations paragraphs*]

[*Opinion paragraph*]

In our opinion, management's assertion that, except for the effect of the material weakness described in its report, [*identify management's assertion, for example, W Company maintained an effective internal control structure over financial reporting as of December 31, 19XX*] is fairly stated, in all material respects, based upon [*identify established or stated criteria*].

[*Explanatory paragraph*]

As discussed in management's assertion, the following material weakness exists in the design or operation of the internal control structure of W Company in effect at [*date*]. [*Describe the material weakness and its effect on the achievement of the objectives of the control criteria.*][10] A material weakness is a condition that precludes the entity's internal control structure from providing reasonable assurance that material misstatements in the financial statements will be prevented or detected on a timely basis.[11]

56. *Disagreements With Management.* In some circumstances, management may disagree with the practitioner over the existence of a material weakness and, therefore, not include in its assertion a description of such a weakness and its effect on the achievement of the objectives of the control criteria. In such cases, the practitioner should express either a qualified or an adverse opinion on management's assertion, depending on the significance of the weakness and its effect on the achievement of the objectives of the control criteria.

[9] As stated in paragraph 39, the existence of a material weakness precludes management from asserting that an entity's internal control structure is effective.

[10] The language used by the practitioner ordinarily should conform with management's description of the effect of the material weakness on the effectiveness of the entity's internal control structure.

[11] This description of a material weakness differs from the definition of material weakness discussed in paragraph 39. Although a practitioner should consider the definition contained in paragraph 39 when determining whether a material weakness exists, the description above should be used to describe a material weakness in the practitioner's report.

57. In other circumstances, management may describe a material weakness but not modify its assertion that the entity's internal control structure is effective.[12] In this case, the practitioner should express either a qualified or an adverse opinion on management's assertion, depending on the significance of the weakness and its effect on the achievement of the objectives of the control criteria.

58. The following is the form of the report a practitioner should use when he or she concludes that a qualified opinion is appropriate in the circumstances.

> Independent Accountant's Report
>
> [*Standard introductory, scope, and inherent limitations paragraphs*]
>
> [*Explanatory paragraph*]
>
> Our examination disclosed the following condition, which we believe is a material weakness in the design or operation of the internal control structure of W Company in effect at [*date*]. [*Describe the material weakness and its effect on the achievement of the objectives of the control criteria.*] A material weakness is a condition that precludes the entity's internal control structure from providing reasonable assurance that material misstatements in the financial statements will be prevented or detected on a timely basis.
>
> [*Opinion paragraph*]
>
> In our opinion, except for the effect of the material weakness described above, management's assertion [*identify management's assertion, for example, that W Company maintained an effective internal control structure over financial reporting as of December 31, 19XX*] is fairly stated, in all material respects, based upon [*identify established or stated criteria*].

59. The following is the form of the report a practitioner should use when he or she concludes that an adverse opinion is appropriate in the circumstances.

> Independent Accountant's Report
>
> [*Standard introductory, scope and inherent limitations paragraphs*]
>
> [*Explanatory paragraph*]
>
> Our examination disclosed the following condition, which we believe is a material weakness in the design or operation of the internal control structure of W Company in effect at [*date*]. [*Describe the material weakness and its effect on achievement of the objectives of the control criteria.*] A material weakness is a condition that precludes the entity's internal control structure from providing reasonable assurance that material misstatements in the financial statements will be prevented or detected on a timely basis.
>
> [*Opinion paragraph*]
>
> In our opinion, because of the effect of the material weakness described above on the achievement of the objectives of the control criteria, management's assertion [*identify management's assertion, for example, that W Company maintained an effective internal control structure over financial reporting as of December 31, 19XX*] is not fairly stated based upon [*identify established or stated criteria*].

60. If management's assertion contains a statement that management believes the cost of correcting the weakness would exceed the benefits to be derived from implementing the new policies and procedures, the practitioner should disclaim an opinion on management's cost-benefit statement. The practitioner may use the following sample language to disclaim an opinion on management's cost-benefit statement:

> We do not express an opinion or any other form of assurance on management's cost-benefit statement.

However, if the practitioner believes that management's cost-benefit statement is a material misstatement of fact, he or she should consider the guidance in paragraphs 80 and 81 and take appropriate action.

61. *Management's Assertion Includes the Material Weakness and Is Presented in a Document Containing the Audit Report.* If the practitioner issues an examination report on management's assertion about the effectiveness of the entity's internal control structure within the same document that includes his or her audit report on the entity's financial statements, the following sentence should be included in the paragraph of the examination report that describes the material weakness:

> These conditions were considered in determining the nature, timing, and extent of audit tests applied in our audit of the 19XX financial statements, and this report does not affect our report dated [*date of report*] on these financial statements.

Scope Limitations

62. An unqualified opinion on management's assertions about the effectiveness of the entity's internal control structure can be expressed only if the practitioner has been able to apply all the procedures he or she considers necessary in the circumstances. Restrictions on the scope of the engagement, whether imposed by the client or by the circumstances, may require the practitioner to qualify or disclaim an opinion. The practitioner's decision to qualify or disclaim an opinion because of a scope limitation depends on his or her assessment of the importance of the omitted procedure(s) to his or her ability to form an opinion on management's assertion about the effectiveness of the entity's internal control structure.

63. For example, management may have implemented control procedures to correct a material weakness identified prior to the date of its assertion. However, unless the practitioner has been able to obtain evidence that the new procedures were appropriately designed and have been operating effectively for a sufficient period of time,[13] he or she should refer to the material weakness described in the report and qualify his or her opinion on the basis of a scope limitation. The following is the form of the report a practitioner should use when restrictions on the scope of the examination cause the practitioner to issue a qualified opinion.

[12] See footnote 10.

[13] See guidance in paragraph 33.

Independent Accountant's Report

[*Standard introductory paragraph*]

[*Scope paragraph*]

Except as described below, our examination was made in accordance with standards established by the American Institute of Certified Public Accountants and, accordingly, included obtaining an understanding of the internal control structure over financial reporting, testing and evaluating the design and operating effectiveness of the internal control structure, and such other procedures as we considered necessary in the circumstances.

[*Standard inherent limitations paragraph*]

[*Explanatory paragraph*]

Our examination disclosed the following material weaknesses in the design or operation of the internal control structure of W Company in effect at [*date*]. A material weakness is a condition that precludes the entity's internal control structure from providing reasonable assurance that material misstatements in the financial statements will be prevented or detected on a timely basis. Prior to December 20, 19XX, W Company had an inadequate system for recording cash receipts, which could have prevented the Company from recording cash receipts on accounts receivable completely and properly. Therefore, cash received could have been diverted for unauthorized use, lost, or otherwise not properly recorded to accounts receivable. Although the Company implemented a new cash receipts system on December 20, 19XX, the system has not been in operation for a sufficient period of time to enable us to obtain sufficient evidence about its operating effectiveness.

[*Opinion paragraph*]

In our opinion, except for the effect of matters we may have discovered had we been able to examine evidence about the effectiveness of the new cash receipts system, management's assertion [*identify management's assertion, for example, that W Company maintained an effective internal control structure over financial reporting as of December 31, 19XX*] is fairly stated, in all material respects, based upon [*identify established or stated criteria*].

64. When restrictions that significantly limit the scope of the examination are imposed by the client, the practitioner generally should disclaim an opinion on management's assertion about the effectiveness of the entity's internal control structure.

Opinion Based in Part on the Report of Another Practitioner

65. When another practitioner has examined management's assertion about the effectiveness of the internal control structure of one or more subsidiaries, divisions, branches, or components of the entity, the practitioner should consider whether he or she may serve as the principal practitioner and use the work and reports of the other practitioner as a basis, in part, for his or her opinion on management's assertion. If the practitioner decides it is appropriate for him or her to serve as the principal practitioner, he or she should then decide whether to make reference in the report to the examination performed by the other practitioner. In these circumstances, the practitioner's considerations are similar to those of the independent auditor who uses the work and reports of other independent auditors when reporting on an entity's financial statements. AU section 543, "Part of Audit Performed By Other Independent Auditors" (AICPA, *Professional Standards*, vol. 1), which provides guidance on (*a*) the auditor's considerations when deciding whether he or she may serve as the principal auditor and, if so, whether to make reference to the examination performed by the other practitioner and (*b*) the form and content of the report, may be useful to the practitioner.

66. When the practitioner decides to make reference to the report of the other practitioner as a basis, in part, for the practitioner's opinion on management's assertion, the practitioner should disclose this fact when describing the scope of the examination and should refer to the report of the other practitioner when expressing the opinion. The following form of the report is appropriate in these circumstances.

Independent Accountant's Report

[*Introductory paragraph*]

We have examined management's assertion [*identify management's assertion, for example, that W Company maintained an effective internal control structure over financial reporting as of December 31, 19XX*] included in the accompanying [*title of management report*]. We did not examine management's assertion about the effectiveness of the internal control structure over financial reporting of B Company, a wholly owned subsidiary, whose financial statements reflect total assets and revenues constituting 20 and 30 percent, respectively, of the related consolidated financial statement amounts as of and for the year ended December 31, 19XX. Management's assertion about the effectiveness of B Company's internal control structure over financial reporting was examined by other accountants whose report has been furnished to us, and our opinion, insofar as it relates to management's assertion about the effectiveness of B Company's internal control structure over financial reporting, is based solely on the report of the other accountants.

[*Standard scope and inherent limitations paragraphs*]

[*Opinion paragraph*]

In our opinion, based on our examination and the report of the other accountants, management's assertion [*identify management's assertion, for example, that W Company maintained an effective internal control structure over financial reporting as of December 31, 19XX*] is fairly stated, in all material respects, based upon [*identify established or stated criteria*].

Subsequent Events

67. Changes may occur subsequent to the date of management's assertion but before the date of the practitioner's report. As described in paragraph 45, the practitioner should obtain management's representations relating to changes that might have occurred subsequent to the date of its assertion that might significantly affect the internal control structure and, therefore, the practitioner's report. Additionally, to obtain information about whether changes have occurred that might affect management's assertion about

the effectiveness of the entity's internal control structure and, therefore, the practitioner's report, he or she should inquire about and examine, for this subsequent period, the following:

a. Relevant internal auditor reports issued during the subsequent period
b. Independent auditor reports (if other than the practitioner's) of reportable conditions or material weaknesses
c. Regulatory agency reports on the entity's internal control structure
d. Information about the effectiveness of the entity's internal control structure obtained through other professional engagements

68. If the practitioner obtains knowledge about subsequent events that he or she believes significantly affect management's assertions about the effectiveness of the entity's internal control structure as of the date of management's assertion, the practitioner should ascertain that management has adequately described in its assertion these events and their effect on the internal control structure. If management has not included such a description and appropriately modified its assertion, the practitioner should add to his or her report an explanatory paragraph that includes such a description.

69. The practitioner has no responsibility to keep informed of events subsequent to the date of his or her report; however, the practitioner may later become aware of conditions that existed at that date that might have affected the practitioner's opinion had he or she been aware of them. The practitioner's consideration of such subsequent information is similar to an auditor's consideration of information discovered subsequent to the date of the report on an audit of financial statements described in AU section 561, "Subsequent Discovery of Facts Existing at the Date of the Auditor's Report" (AICPA, *Professional Standards*, vol. 1). The guidance in that section requires the auditor to determine whether the information is reliable and whether the facts existed at the date of his or her report. If so, the auditor considers (*a*) whether the facts would have changed the report if he or she had been aware of them and (*b*) whether there are persons relying on management's assertion about the effectiveness of the entity's internal control structure. Based on these considerations, detailed guidance is provided for the auditor in paragraph 6 of AU section 561.

Management's Assertion About the Effectiveness of a Segment of the Entity's Internal Control Structure

70. When engaged to report on management's assertion about the effectiveness of only a segment of an entity's internal control structure (for example, the internal control structure over financial reporting of an operating division), a practitioner should follow the guidance in this Statement and issue a report using the guidance in paragraphs 48 through 64, modified to refer to the segment of the entity's internal control structure examined. In this situation, the practitioner may use a report such as the following.

Independent Accountant's Report

[*Introductory paragraph*]

We have examined management's assertion [*identify management's assertion, for example, that W Company's retail division maintained an effective internal control structure over financial reporting as of December 31, 19XX*], included in the accompanying [*title of management report*].

[*Standard scope and inherent limitations paragraphs*]

[*Opinion paragraph*]

In our opinion, management's assertion [*identify management's assertion, for example, that W Company's retail division maintained an effective internal control structure over financial reporting as of December 31, 19XX*] is fairly stated, in all material respects, based upon [*identify established or stated criteria*].

Management's Assertion About the Suitability of Design of the Entity's Internal Control Structure

71. Management may present an assertion about the suitability of the design of the entity's internal control structure for preventing or detecting material misstatements on a timely basis and request the practitioner to examine and report on the assertion. For example, prior to granting a new casino a license to operate, a regulatory agency may request a report on whether the internal control structure that management plans to implement will provide reasonable assurance that the control objectives specified in the regulatory agency's regulations will be achieved. When evaluating the suitability of design of the entity's internal control structure for the regulatory agency's purpose, the practitioner should obtain an understanding of the elements of the internal control structure[14] that management should implement to meet the control objectives of the regulatory agency and identify the internal control structure policies and procedures that are relevant to those control objectives.

72. The following is a suggested form of report a practitioner may issue.[15] The actual form of the report should be modified, as appropriate, to fit the particular circumstances.[16]

Independent Accountant's Report

[*Introductory paragraph*]

We have examined management's assertion [*identify management's assertion, for example, that W Casino's internal control structure over financial reporting is suitably designed to prevent or detect material misstatements*

[14] See paragraph 24.

[15] Nothing in this section is intended to preclude the practitioner from using the reports on the design of a system contained in the AICPA's Audit and Accounting Guide *Audits of Casinos*.

[16] This report assumes that the control criteria of the regulatory agency have been subjected to due process and, therefore, are considered reasonable criteria for reporting purposes. Therefore, there is no limitation on the distribution of this report.

> *in the financial statements on a timely basis as of December 31, 19XX*] included in the accompanying [*title of management report*].
>
> [*Scope paragraph*]
>
> Our examination was made in accordance with standards established by the American Institute of Certified Public Accountants and, accordingly, included obtaining an understanding of the internal control structure over financial reporting, evaluating the design of the internal control structure, and such other procedures as we considered necessary in the circumstances. We believe that our examination provides a reasonable basis for our opinion.
>
> [*Standard inherent limitations paragraph*]
>
> [*Opinion paragraph*]
>
> In our opinion, management's assertion [*identify management's assertion, for example, that W Casino's internal control structure over financial reporting is suitably designed to prevent or detect material misstatements in the financial statements on a timely basis as of December 31, 19XX*] is fairly stated, in all material respects, based upon [*identify established or stated criteria*].

When management presents such an assertion about an entity's internal control structure that has already been placed in operation, the practitioner should modify his or her report by adding the following to the scope paragraph of the report:

> We were not engaged to examine and report on the operating effectiveness of W Casino's internal control structure over financial reporting as of December 31, 19XX, and, accordingly, we express no opinion on it.

Management's Assertion Based on Criteria Specified by a Regulatory Agency That Did Not Follow Due Process

73. A governmental or other agency that exercises regulatory, supervisory, or other public administrative functions may establish its own criteria and require reports on the internal control structures of entities subject to its jurisdiction. Criteria established by a regulatory agency may be set forth in audit guides, questionnaires, or other publications. The criteria may encompass specified aspects of an entity's internal control structure and specified aspects of administrative control or compliance with grants, regulations, or statutes. If such criteria have been subjected to due process procedures, including the broad distribution of proposed criteria for public comment, a practitioner should use the form of report illustrated in paragraph 48 or 51, depending on the manner in which management presents its assertion. If, however, such criteria have not been subjected to due process procedures, the practitioner should modify the report by adding a separate paragraph that limits the distribution of the report to the regulatory agency and to those within the entity.

74. If a regulatory agency requires management to report all conditions (whether material or not) that are not in conformity with the agency's criteria, the practitioner should determine whether all conditions of which he or she is aware have been reported by management. If the practitioner concludes that management has not reported all such conditions, he or she should describe them in the report.

75. For purposes of these reports, a material weakness is—

a. A condition in which the design or operation of one or more of the specific internal control structure elements does not reduce to a relatively low level the risk that errors or irregularities in amounts that would be material in relation to the applicable grant or program might occur and not be detected on a timely basis by employees in the normal course of performing their assigned functions.

b. A condition in which the lack of conformity with the regulatory agency's criteria is material in accordance with any guidelines for determining materiality that are included in such criteria.

76. When the practitioner issues this form of report, he or she does not assume any responsibility for the comprehensiveness of the criteria established by the regulatory agency. However, the practitioner should report any condition that comes to his or her attention during the course of the examination that he or she believes is a material weakness, even though it may not be covered by the criteria.

77. The following report illustrates one that a practitioner might use when he or she has examined management's assertion about the effectiveness of the entity's internal control structure based upon criteria established by a regulatory agency.

> Independent Accountant's Report
>
> [*Introductory paragraph*]
>
> We have examined management's assertion included in its representation letter dated February 15, 19XY, [*identify management's assertion, for example, that W Company's internal control structure over financial reporting as of December 31, 19XX is adequate to meet the criteria established by ______ agency, as set forth in its audit guide dated ______*].
>
> [*Scope paragraph*]
>
> We understand that W Company has been awarded a grant of [*amount*] from [*agency*] for the period [*date*] through [*date*]. We have examined, in accordance with standards established by the American Institute of Certified Public Accountants, management's assertion about the adequacy of specific internal control structure policies and procedures over financial reporting to meet the criteria established by [*agency*], as set forth in section ______ of its audit guide issued [*date*]. Accordingly, our examination included such procedures as we considered necessary in the circumstances. We believe that our examination provides a reasonable basis for our opinion.
>
> [*Inherent limitations paragraph*]
>
> Because of inherent limitations in any internal control structure, errors or irregularities may occur and not be detected. Also, projections of any evaluation of the internal control structure over financial reporting to future periods is subject to the risk that the internal control structure may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

[*Opinion paragraph*]

We understand that the agency considers internal control structure policies and procedures over financial reporting that meet the criteria referred to in the second paragraph of this report adequate for its purpose. In our opinion, based on this understanding and on our examination, management's assertion [*identify management's assertion, for example, that W Company's internal control structure over financial reporting is adequate to meet the criteria established by ______ agency*] is fairly stated, in all material respects, based upon such criteria.

[*Limitation on distribution paragraph*]

This report is intended for the information and use of the board of directors and management of W Company and [*agency*] and should not be used by other third parties for any other purpose.

OTHER INFORMATION IN A CLIENT-PREPARED DOCUMENT CONTAINING MANAGEMENT'S ASSERTION ABOUT THE EFFECTIVENESS OF THE ENTITY'S INTERNAL CONTROL STRUCTURE

78. An entity may publish various documents that contain other information in addition to management's assertion on the effectiveness of the entity's internal control structure and the practitioner's report thereon. The practitioner may have performed procedures and issued a report covering this other information (for example, an audit report on the entity's financial statements), or another practitioner may have done so. Otherwise, the practitioner's responsibility with respect to other information in such a document does not extend beyond the management report identified in his or her report, and the practitioner has no obligation to perform any procedures to corroborate any other information contained in the document. However, the practitioner should read the other information not covered by the practitioner's report or by the report of the other practitioner and consider whether it, or the manner of its presentation, is materially inconsistent with the information appearing in management's report, or with the manner of its presentation.

79. If the practitioner believes that the other information is inconsistent with the information appearing in management's report, he or she should consider whether management's report, the practitioner's report, or both require revision. If the practitioner concludes that these do not require revision, he or she should request management to revise the other information. If the other information is not revised to eliminate the material inconsistency, the practitioner should consider other actions, such as revising his or her report to include an explanatory paragraph describing the material inconsistency, withholding the use of his or her report in the document, or withdrawing from the engagement.

80. If the practitioner discovers in the other information a statement that he or she believes is a material misstatement of fact, he or she should discuss the matter with management. In connection with this discussion, the practitioner should consider whether he or she possesses the expertise to assess the validity of the statement, whether standards exist by which to assess the manner of presentation of the information, and whether there may not be valid differences of judgment or opinion. If the practitioner concludes that a material misstatement exists, the practitioner should propose that management consult with some other party whose advice might be useful, such as the entity's legal counsel.

81. If, after discussing the matter, the practitioner concludes that a material misstatement of fact remains, the action taken will depend on his or her judgment in the circumstances. The practitioner should consider steps such as notifying the entity's management and audit committee in writing of his or her views concerning the information and consulting his or her legal counsel about further action appropriate in the circumstances.

RELATIONSHIP OF THE PRACTITIONER'S EXAMINATION OF AN ENTITY'S INTERNAL CONTROL STRUCTURE TO THE OPINION OBTAINED IN AN AUDIT

82. The purpose of a practitioner's examination of management's assertion about the effectiveness of an entity's internal control structure is to express an opinion about whether management's assertion that the entity maintained an effective internal control structure as of a point in time is fairly stated in all material respects, based on the control criteria. In contrast, the purpose of an auditor's consideration of the internal control structure in an audit of financial statements conducted in accordance with generally accepted auditing standards is to enable the auditor to plan the audit and determine the nature, timing, and extent of tests to be performed. Ultimately, the results of the auditor's tests will form the basis for the auditor's opinion on the fairness of the entity's financial statements in conformity with generally accepted accounting principles. The auditor's responsibility in considering the entity's internal control structure is discussed in SAS No. 55, *Consideration of the Internal Control Structure in a Financial Statement Audit.*

83. In a financial statement audit, the auditor obtains an understanding of the internal control structure by performing procedures such as inquiries, observations, and inspection of documents. After he or she has obtained this understanding, the auditor assesses the control risk for assertions related to significant account balances and transaction classes. The auditor assesses control risk for an assertion at maximum if he or she believes that policies and procedures are unlikely to pertain to the assertion, that policies and procedures are unlikely to be effective, or that an evaluation of their effectiveness would be inefficient. When the auditor assesses control risk for an assertion at below maximum, he or she

identifies the internal control structure policies and procedures that are likely to prevent or detect material misstatements in that assertion and performs tests of controls to evaluate the effectiveness of such policies and procedures.

84. Although an auditor's consideration of the internal control structure in a financial statement audit generally is more limited than that of a practitioner engaged to examine management's assertion about the effectiveness of the entity's internal control structure, the two considerations are similar in nature. Thus, knowledge the practitioner obtains about the entity's internal control structure as part of the examination of management's assertion may serve as the basis for his or her understanding of the internal control structure in an audit of the entity's financial statements. Similarly, the practitioner may consider the results of tests of controls performed in connection with an examination of management's assertion, as well as any material weaknesses identified, when assessing control risk in the audit of the entity's financial statements.

85. While an examination of management's assertions about the effectiveness of the entity's internal control structure and an audit of the entity's financial statements may be performed by the same practitioner, the former can be performed by a different practitioner as long as he or she obtains the necessary understanding of the entity's internal control structure as described in paragraph 25. If the audit of the entity's financial statements is performed by another practitioner, the practitioner may wish to consider any material weaknesses and reportable conditions identified by the auditor and identify any disagreements between management and the auditor concerning such matters.

RELATIONSHIP TO THE FOREIGN CORRUPT PRACTICES ACT

86. The Foreign Corrupt Practices Act of 1977 (FCPA) includes provisions regarding internal accounting control for entities subject to the Securities and Exchange Act of 1934. Whether an entity is in compliance with those provisions of the FCPA is a legal determination. A practitioner's examination report issued under this Statement does not indicate whether an entity is in compliance with those provisions.

EFFECTIVE DATE

87. This Statement is effective for an examination of management's assertion on the effectiveness of an entity's internal control structure over financial reporting begining after December 15, 1993. Earlier application of this Statement is encouraged.

APPENDIX

The following Statements on Auditing Standards (SASs) contain guidance for practitioners engaged to provide other services in connection with an entity's internal control structure.

- SAS No. 60, *Communication of Internal Control Structure Related Matters Noted in an Audit* (AICPA, *Professional Standards,* vol. 1, AU sec. 325), provides guidance on identifying and communicating reportable conditions that come to the auditor's attention during an audit of financial statements.
- SAS No. 68, *Compliance Auditing Applicable to Governmental Entities and Other Recipients of Governmental Financial Assistance* (AICPA, *Professional Standards,* vol. 1, AU sec. 801), provides guidance to auditors on reporting on an entity's internal control structure in audits conducted in accordance with Government Auditing Standards.
- SAS No. 70, *Reports on the Processing of Transactions by Service Organizations* (AICPA, *Professional Standards,* vol. 1, AU sec. 642), provides guidance to auditors of a service organization on issuing a report on certain aspects of the service organization's internal control structure that can be used by other auditors, as well as guidance on how other auditors should use such reports.